April 11, 2011

MERITAS ADVISORS

Comprehensive Wealth Management

Monthly Investment Outlook

Highlights:

- *The Economy*
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- *Housing*
- *Consumer Credit*
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Northern California
4040 Civic Center Drive
Suite 200
San Rafael, CA 94903
415.690.8547

Southern California
11622 El Camino Real
Suite 100
San Diego, CA 92130
858.461.8547

info@MeritasAdvisors.com
www.MeritasAdvisors.com

Strength and Stability in Volatile Times

Meritas seeks to generate returns for our clients that are independent of the direction of the economy.

By allocating across a range of asset classes, chosen for their ability to perform and behave differently from each other over time, we seek to create portfolios that do not require a strong economy or a bullish market to generate stable and positive returns.

Dear Clients and Friends: This month we decided to focus on our domestic markets more than in previous months. Weôll be back to our usual global view next month. We hope you find our commentary informative and as always, welcome your feedback.
Lenore Hawkins, MBA, Principal

The Economy*:* Many of the economic factors present prior to the near 20% correction last spring/summer are back, with some new ones (No. 5-8) to join them:

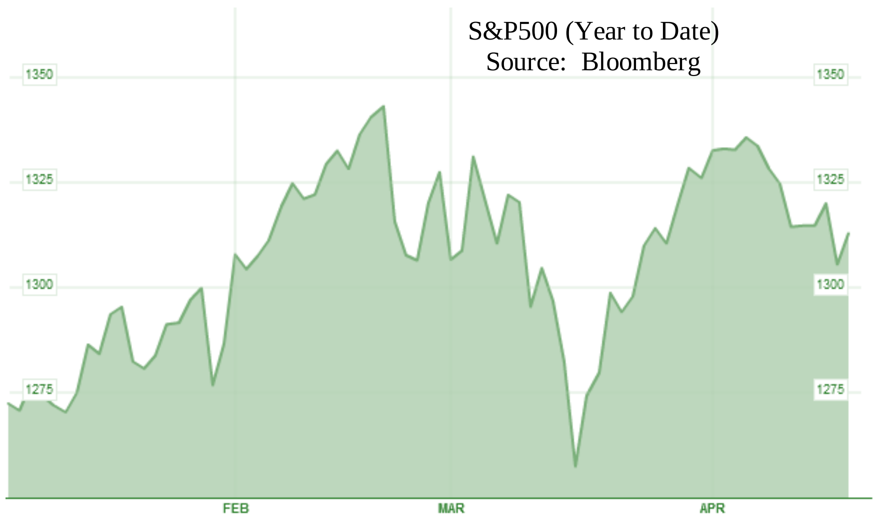
1. End of quantitative easing. Since the beginning of 2009 there has been an 88% correlation between the growth of the Fedôs balance sheet and the S&P, (more on how this might play out later).
2. Decline in fiscal support with federal, state and municipal spending all expected to pull back.
3. European sovereign default risk. Greece is back in the news and its two year yield is over 20%. (20% to borrow money for 2 years!)
4. Slowing U.S. economy. GDP growth forecasts for 2011 have dropped from the 4% range to 2% in recent weeks.
5. Prices at the pump higher and rising. Weôve seen roughly a $1 increase per gallon, which is the equivalent of a $130 billion tax hike for households. If prices increase another $0.30 to $0.40, which looks likely, that would be akin to a $180 billion tax hike or 3% wage cut.
6. Unrest in the Middle East. Howôs that for an understatement?
7. China is attempting to tighten credit with required bank reserves now over 20%. Inflation is getting more worrisome in emerging markets.
8. Real wages, which takes into account inflation, have fallen for 5 consecutive months.

The chart below gives an indication of shipping levels. It is trending down which could indicate slowing in global trade. Weôve also seen a sharp decline in the Producer Price Index for Containers, another possible sign of contraction in shipping, which supports the hypothesis of declining global trade.

Baltic Dry Shipping Index May 2010-April 2011
Source: Bloomberg

In the face of all this, the Fed could get around ending QE2 in June by continuing to reinvest the approximately $17 billion/month in maturing mortgage debt on their books. This would allow the Fed to postpone reducing its balance sheet in June, removing one of the significant negatives for the stock market in the near term. ***Bottom Line****: Signs that we should expect a slowdown in the growth of the economy, but the Fed could postpone a market downturn by continuing its policy of loose money which will continue to push risk assets up, (think stocks and commodities) and the dollar down.*

Domestic Markets: Are the markets overheated? Investor-based leverage growth would certainly indicate they are. Margin account borrowing, the money investors borrow to buy stocks, bonds etc., rose by $20.7 billion in February alone, which represents a 129% increase at an annual rate. In the past three months, credit to buy stocks has increased at an average annual rate of 64%. To put the margin account balance in context, the only times weǿve seen similar rises were (1) during the tech bubble of the late 1990s and (2) the credit bubble four years ago. This is consistent with risk appetite increasing as investors seek returns to compensate for a falling dollar. From the chart on the right, we can see that for all the talk of how we are in a bull market, the S&P500 peaked on February 18th. If we look at the S&P500 and exclude energy, the performance is significantly worse. Earnings are coming in fairly strong so far, but with some concerns over performance from revenue growth vs. improvement based on cost cutting, which cannot continually deliver improved earnings. ***Bottom Line****: We've seen two months of lots of movement in the markets, but are still below this year's peak levels. We are paying close attention during the earnings season and particularly to the first quarter's GDP growth when it comes out later this month. In this third year since the start of the recovery, specific investment selection becomes more critical than in the first two years.*

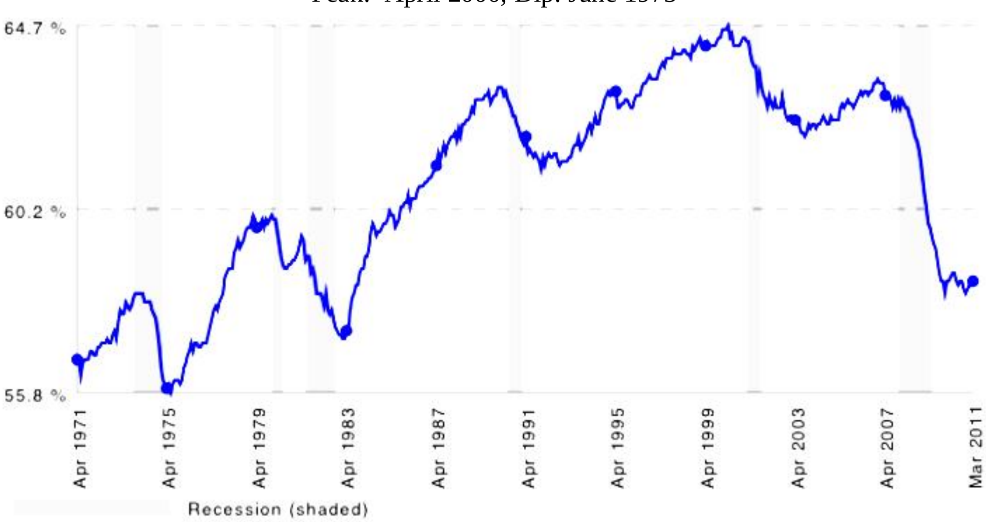


S&P500 (Year to Date)
Source: Bloomberg

Employment: On April 1st we saw civilian employment as a percentage of the population increase 0.2% from February 2011 to 58.5% . This is a disappointing 0.2% drop from a year ago, and is 5.6% below the January 2008 levels. Usually by the third year of an expansion payroll is at a new all-time high, but this time the economy has only regained about 17% of the recession job losses. As an additional note of caution, energy and food now absorb about 23% of U.S. household wages, which is historically a red flag level for the American consumer as it impacts discretionary spending. ***Bottom Line****: We are hearing talk of improving employment, but we are still at levels not seen in almost 30 years. Robust economic growth is challenging at best with such a low percentage of the population bringing home paychecks.*

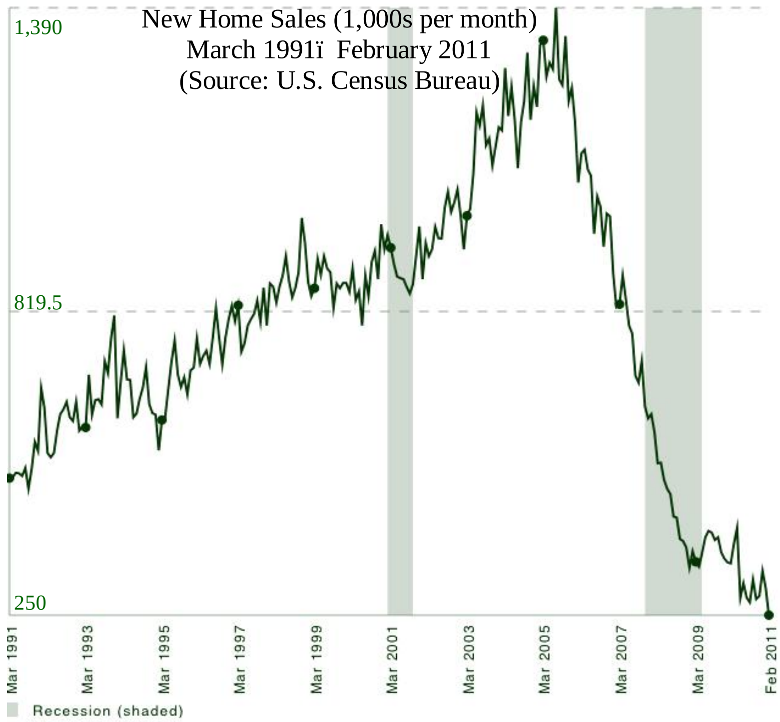
On the other hand, unit labor costs have nearly a 90% correlation with inflation. So while we have plenty of reasons to be concerned about inflation in the long-run, low employment levels should help keep it at bay for the time being.

Civilian Employment as a Percentage of the Population
(Source : Bureau of Labor Statistics)
Peak: April 2000, Dip: June 1975



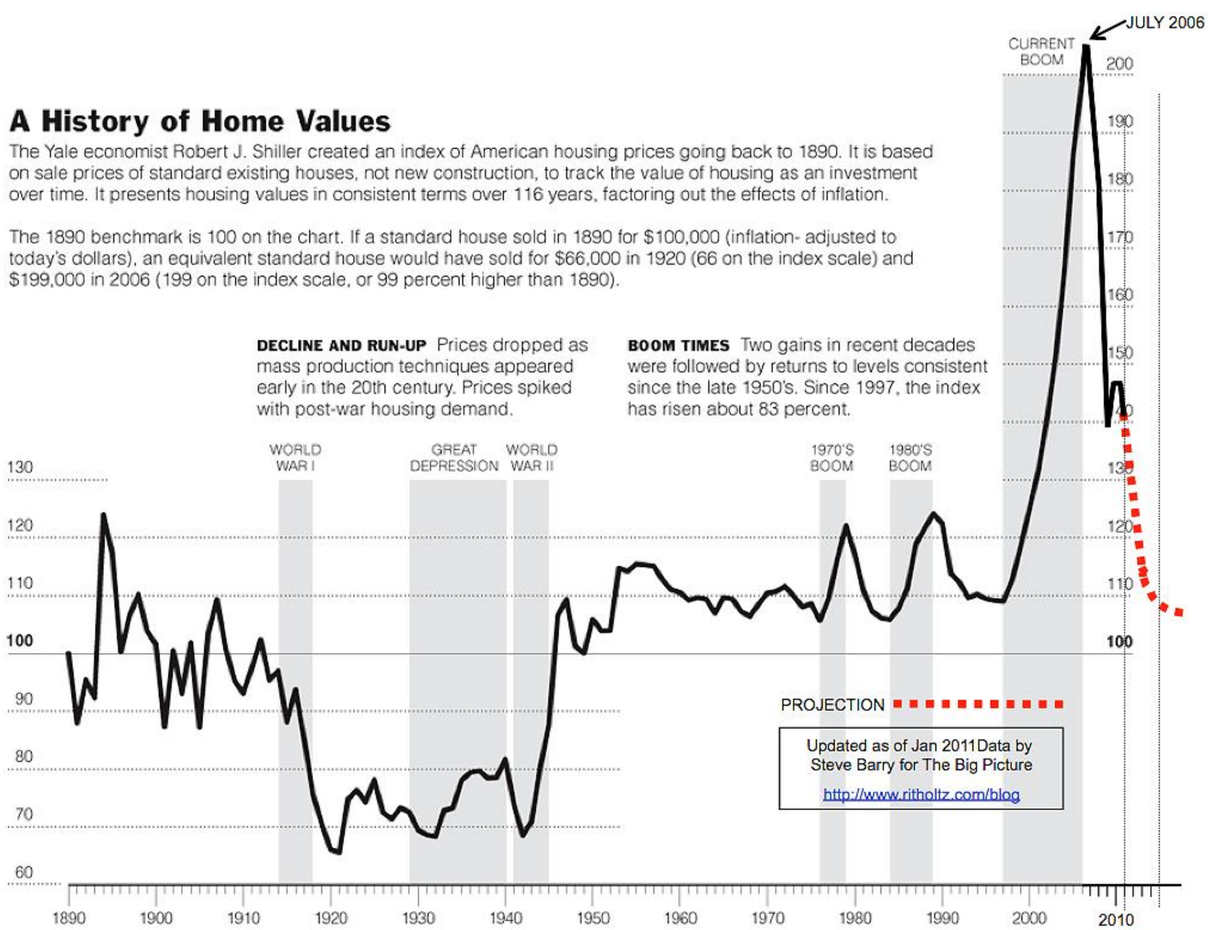
Housing: New home sales in February were 250,000, a 16.9% decrease from January and a 28% decrease from February 2010. Home sales peaked in July 2005 and are currently at their lowest levels since January 1963, when data tracking began.

- *3.7 million homes* are vacant and for sale - 30% above normal. (U.S. Census)
- *3.5 million homes* are occupied but with a for sale sign on the front lawn - 50% above normal. (National Association of Realtors estimate)
- *1.8 million homes* are considered distressed, which are homes in arrears or in the foreclosure pipeline. (CoreLogic estimate)

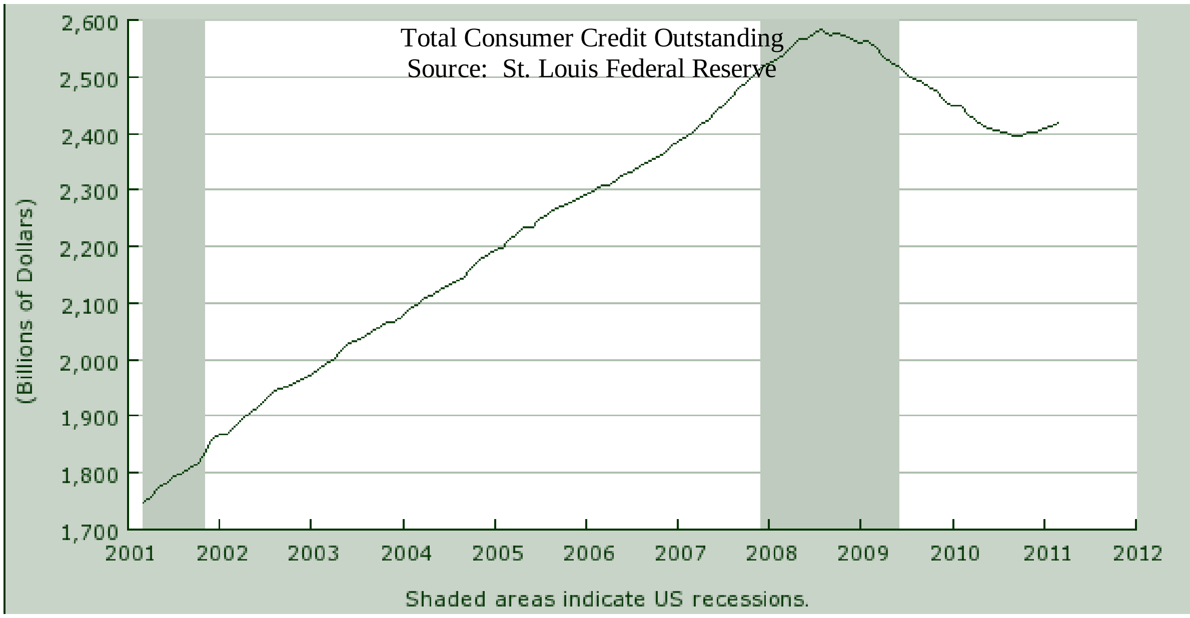


That's 9 million homes! It could easily take five plus years to clean up all this excess supply and finally provide a bottom for home prices on a national level. ***Bottom Line:*** *With employment at 30 year lows, real wages declining for 5 consecutive months and the primary source of savings for most families, namely their home, dropping in value, we don't see how consumer spending will support significant growth in GDP for the time being. But remember, the economy and the investment markets don't always move in unison.*

Below is a chart put together by Barry Ritholtz to give you an idea of housing prices from a historical perspective.



Consumer Credit: The economic expansion of the past few decades was driven in large part by a growth in consumer credit. The rising level of consumer spending was financed not through higher income, but rather by borrowing more, primarily against homes. We are now seeing a continued drop in total consumer credit outstanding as households clean up their finances. Although credit did rise $7.6 billion in February, which is the largest increase since June 2008, that is on a seasonally adjusted basis. In raw terms it contracted $16.4 billion. So what was the source of this credit? Mostly student loans to the tune of $8.2 billion. This means that outside of student loans, consumer credit actually contracted yet again. It turns out that in the past year, student credit has increased $145 billion while total consumer credit has declined $15 billion. Thatõs a $160 billion decline in consumer credit if we exclude Federal student loans! ***Bottom Line****: Spending is not going to be augmented by borrowing anytime soon, which is a headwind to GDP growth as consumer spending has historically accounted for 70% of GDP.*



Wrap up: March was a painful month as we watched in horror the tragedy in Japan. I cannot imagine what it must have been like to first experience an earthquake of that magnitude and then to have a tsunami of biblical proportions take away so much of what was known and loved. We look over to Europe and the sovereign debt crisis is only getting worse, the Middle East continues its unnerving battles and Kirstie Alley just canõt catch a break on Dancing with the Stars. Sometimes you just have to find a way to laugh in the face of tragedy (or public humiliation), pick yourself up and carry on.

It is time to be very cautious as domestic economic fundamentals are not conducive to significant growth in the near-term. However, most of the rest of the world is struggling too, so the markets can act quite wonky, (technical term) as investors look for someplace to generate returns. While we are long-term, value investors at heart, this is a very tough time for buy and hold strategies. If the Fed stops monetizing the Treasuryõs spending, we could see a rebound in the dollar. If the dollar comes roaring back, commodities, including gold and silver, would most likely take a fairly hard hit. However, the longer-term trend for rising sovereign debt and high levels of government spending translates into a declining dollar versus other currencies and the precious metals. We would not be surprised to see alternating periods of a rising U.S. dollar and deflation followed by a falling dollar and inflation. As the developed nations work through the debt pickle and emerging markets deal with the ramifications of their own policies as well as the developing nationsô loose money, expect more wild market fluctuations. Now more than ever since the recovery began, specific investment selection is key as the rising tide will no longer lift all boats.

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